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Could Congress' Retirement Plan Serve as a Model to Reform Social Security?

"You will be guaranteed benefits as good as what members of Congress get."
[First Lady Hillary Rodham Clinton, Speech to the United Auto Workers, Washington, DC, 3/22/94]

"As good as what members of Congress get," was the mantra by which the Clinton Administration sought to sell America on a nationalized health care system. It was a powerful enough pitch to convince the liberals, but it failed because people did not want to nationalize one-seventh of America's economy and simultaneously lose much of their freedom to choose. However, the "as good as what Congress gets" rallying cry may yet serve a purpose — *if* applied to a contrary program, one that would *increase* freedom to choose, and one that *privatizes* rather than nationalizes: a marriage between Social Security and private investment.

Members of Congress (and 2.3 million current and former federal employees) are privileged to participate in a supplementary retirement program known as the Thrift Savings Plan (TSP). It is the world's largest such plan in terms of number of participants, and is a "defined contribution" plan (in contrast to a "defined benefit" plan like Social Security, where a particular benefit is guaranteed on retirement). Both the employee and the employer make deposits equal to a percentage of the employee's pre-tax wages into the plan during the years of employment and benefits are then withdrawn upon retirement. While federal employees have very limited access to the funds prior to retirement, they have continuous control over them, determining where and in what percentages their accounts are invested, and receiving regular reports on their earnings. TSP's assets were $55.5 billion in November 1997, making it the largest defined contribution plan in the country, and one of the 12 largest privately invested retirement funds in the country.

The TSP is more than just a federal retirement plan. It could well serve as a model for how the Social Security Administration could begin to offer privately invested, privately held retirement accounts. As actuarial tables of Social Security makes clear, the declining ratio of workers to beneficiaries means *the only feasible future option* for the program is to increase the rate of return on Social Security taxes. Because government is not a bank and never will be, it cannot do this, only the private sector can [see RPC's "What This President Isn't Telling You About Social Security," 2/19/98]. The TSP model presents a tested and proven way to pursue private investment while avoiding many of the pitfalls of other private investment models. As Congress anticipates for the first time in three decades a budget surplus, Members could look to this model as a way to begin to make this transition for Social Security's future.

Social Security Is Unsustainable In Its Current Form

There is no longer any debate and there can be no misunderstanding: Social Security is unsustainable in its current form:

- First, Social Security is a pay-as-you-go program, which means that money collected now pays current benefits. Despite the surpluses that Social Security is now running, *none* of this money can be saved to pay for future benefits — today's money cannot defray tomorrow's costs as the system is now configured.

- Second, Social Security is also a "defined benefit" plan whereby benefits are calculated as a percentage of the employee's earnings. This means that a commitment for benefits is being accrued as people contribute to the system. According to the Social Security Administration, currently, 148.2 million workers are paying 12.4 percent of their gross pay to support 37.7 million current retirees and their survivors (including the disabled, total beneficiaries number 43.8 million); the payers are simultaneously future beneficiaries who are earning defined benefits. The ratio of current workers to current beneficiaries is rapidly declining: in 1950 there were 16.5 covered workers to each beneficiary; in 1997 there were just 3.3 workers to each beneficiary; and, by 2030 there will be just 2 workers per beneficiary.

- Third, the diminishing ratio of covered workers to beneficiaries means that beginning in 2012, Social Security taxes will no longer be able to pay for Social Security benefits. Something will have to be done to make up for this shortfall; however, there is no way that taxes can be raised to such an extent to maintain the status quo because of the diminishing ratio of future workers to beneficiaries. According to the 1997 report of the Social Security trustees, the current 12.4-percent Social Security tax rate would have to be raised another 2.17 points — an unacceptable 18-percent increase — in order to eliminate the deficit in 2020. By 2075, the tax hike would have to be 6.07 percent — nearly a 50-percent increase from the current tax level. Such levels of tax hikes would reduce jobs, savings, and stifle the economic growth necessary for America's continued prosperity.

The Need for Private Investment

As explained above, the Social Security program needs the higher rate of return offered by private investment if it is to meet its future commitments and avoid chronic insolvency. Presently, current obligations are met with current tax receipts, but in just 14 years, that method will be insufficient. The only feasible solution that safeguards America's economic future is to change the fundamental nature of the system so that current tax receipts are actually invested in the private sector and so yield an actual return rather than merely a future commitment from the federal government.

The need for private investment of at least some of Social Security's tax receipts is more than a question of economic necessity. It is also a matter of fairness to beneficiaries and taxpayers as well. Simply, the rate of return on Social Security taxes will increasingly leave retirees relatively worse off than they should be. The average worker retiring in 1997 will recover the value of her own and her employer's contributions in 13.9 years; however, the average worker retiring in 2025 will not recover the value of his and his employer's contributions for 26.2 years — almost twice as long as for those retiring last year.

The report last year by the 1994-1996 Advisory Council on Social Security stated that persons born in 1955 will receive an average annual real rate of return on their Social Security tax payments of about 2 percent, while those persons born after 1955 will receive a return of between just 1 and 2 percent. In contrast, the historic real rate of return on private investment was 7 percent. This percentage disparity translates into thousands of lost dollars to the taxpayer. According to the Heritage Foundation:

> *"A 21-year-old single male making an average income throughout his lifetime can expect to lose $309,400 in potential retirement income by staying in Social Security when compared with what he would earn if he invested his payroll taxes in a safe, conservative private retirement fund made up of 50 percent equities and 50 percent government bonds."*
> ["Social Security's Rate of Return," Heritage Foundation, p. 9]

The report also notes that in an extreme case, "low-income single African-American males born after 1959 actually face a *negative* real rate of return from Social Security."

One Model for Reform: The TSP Program

The need for private investment is obvious, but the means of achieving this are much less so. However, a successful working model for private investment of retirement funds is at hand: the federal Thrift Savings Plan. In fact, most members of Congress and the Administration are already participating in it and know it as a program that works. TSP is almost a perfect test case for Social Security private investment.

TSP began operations in 1987, and was created as part of the Federal Employees' Retirement System (FERS). The former system, the Civil Service Retirement System (CSRS), operated as a defined benefit program — just like Social Security — and as the sole retirement program for federal employees from 1920-1983 (federal employees did not participate in Social Security). In order to shore up Social Security and reform the federal retirement program, the law was changed so that new federal employees hired after 1983 were placed in the FERS program where they would pay Social Security taxes and be eligible for coverage, and have the option of participating in the TSP program.

In a thumbnail sketch of TSP under the FERS program, the federal government automatically contributes an amount equal to 1 percent of an eligible employee's gross pay into a TSP account earmarked for that employee every pay period. The employee has the option of additionally contributing up to 10 percent of his gross, the first 4 percent of which the government will match. By virtue of these contributions, an employee may deposit an amount equal to up to 15 percent of his gross pay into his TSP. As of November 1997, 2.3 million current and former federal employees participate in TSP — making it the world's largest such plan with assets of $55.5 billion. It is projected to receive contributions of $5.6 billion in FY 1999.

The employee has the choice of how his individual TSP account is to be invested among three funds: 'G' — nonmarketable government short-term securities (basically what the Social Security trust fund now has as its sole investment); 'F' — fixed income securities (mixture of government, corporate, and mortgage-backed bonds) that tracks the overall bond market; 'C' — common stock fund that tracks the S&P 500 (Barclay's Equity Index Fund). Participants can place any percentage of their TSP accounts into any of these funds, that is they can divide their funds equally among the three, for example, or they might invest 100 percent of their contributions and earnings into a single fund. The three-funds approach (expanding to five funds in 2000) was chosen for ease of administration.

TSP is administered by the Federal Retirement Thrift Investment Board, an independent government agency composed of five members appointed by the President and confirmed by the Senate, plus an Executive Director. They are required by law to manage TSP prudently and solely in the interest of beneficiaries. The Board contracts with a separate organization to do the recordkeeping (currently USDA's National Finance Center in New Orleans) for all participant records. The Board does not make investment decisions. Currently, the 'C' and 'F' funds are being managed by Barclay's Global Investors under competitively awarded contracts that run for three years (with an option for two additional years). TSP purposely uses a "passive management" approach (choosing a stock index fund, rather than picking individual stocks) for the 'C' and 'F' funds in order to avoid political manipulation and conflicts of interest when investing. TSP investments can only be used to pay benefits and TSP administrative expenses ($40-$50 million annually — or just 7 basis points; in comparison the Vanguard S&P 500 fund, one of the cheapest mutual funds to run, costs 20 basis points to operate). TSP is required by law to submit an annual independent audit, while the Board is audited by the Secretary of Labor.

In short, employees' TSP accounts are entirely their own — from the dollar amount deposited to the allocation among investment funds, while the federal government maintains strictly a fiduciary responsibility.

Why TSP Might Be a Preferable Form of Private Investment

Social Security faces a shortfall in the near future. Investing money now in the private sector would create a return that could alleviate (and eliminate with sufficient investment) this shortfall. Moving Social Security payroll taxes into some type of privately held accounts could take three basic forms:

- Payroll tax cut with individuals holding their own investment accounts, known as privately held and privately invested (PHPI);

- Payroll tax diversion from Social Security payroll taxes to private accounts with individuals determining the investment of money from among a limited range of government-offered options (that is, TSP-like); or

- Payroll tax diversion with government holding and determining the private investments, that is government-held and government-invested (GHGI).

Of these three options, the TSP approach is the preferable one because it combines the strengths of private investment while insulating the holder (and ultimately the general taxpayer) from investment risk.

PHPI accounts would have considerable positive effects, but also some possible negative consequences. The economic impact would be decidedly positive. Since it would be a true tax cut that would go into a retirement account, the effect would be increased investment for the nation and economic growth. The beneficiary impact would also be positive. Individuals' returns (if properly invested and overseen) would be substantially higher than the effective return received from Social Security. However, the risk of an individual making a poor private investment would exist.

GHGI would pose substantial risk to the beneficiary and to the economy. The diversion of federal revenue into the private sector could be positive if done on a sound financial basis. However, if the revenue were used to pursue "social goals" or if the government attempted to pick "winners and losers," it could have a decidedly negative impact on the whole economy: instead of private investing, it could become leverage by which the government gained access to the whole economy. The beneficiary impact would be just as volatile. Individuals' returns (if properly invested and overseen) would be substantially higher than the effective return received from Social Security. However, risk would still remain even if this route were taken. The risk would be far greater if the government did not follow sound investment criteria, possibly endangering the economy as a whole.

The TSP approach is preferable because it avoids the weaknesses while retaining the strengths of the above options. The economic impact would be positive since it would be an effective tax cut coupled with private-sector investment, and so increasing investment and economic growth. The beneficiary impact would also be positive. Individuals' returns would be substantially higher than the effective return received from Social Security. And, while some risk still would be involved from an investment downturn (particularly for those nearing retirement who do not have the years to make up for such a loss), this could be minimized. Government could require a gradually limited exposure to higher risk investments as participants neared retirement. To further reduce personal risk, government could bar pre-retirement access to the account. And the risk of government manipulation would be eliminated by the TSP's passive investment strategy.

Implementing the TSP Approach

The estimated budget surplus would allow for an extensive test of the TSP approach for Social Security by allowing the effective diversion of payroll taxes into TSP accounts. The Congressional Budget Office (CBO) estimates a \$671 billion surplus during the 1999-2008 period. If the entire surplus were invested in Social Security TSP accounts, it would amount to government being able to contribute an amount equal to 1.5 percent of the 12.4 percent payroll tax into individual TSP accounts set aside for each worker.

While in no way endangering Social Security or affecting current benefits, this use of the surplus would allow for a large-scale demonstration program of the TSP approach.

SOCIAL SECURITY TAXES AND BUDGET SURPLUS

Fiscal Year	Social Security Tax Revenue*	Federal Budget Surplus*	Ratio: Surplus to SS Tax	As Percent of 12.4% SS Tax
1999	438.212	9	0.021	0.255
2000	457.745	1	0.002	0.271
2001	477.057	13	0.027	0.338
2002	497.825	67	0.135	1.669
2003	520.708	53	0.102	1.262
2004	545.687	70	0.128	1.591
2005	574.411	75	0.131	1.619
2006	601.202	115	0.191	2.372
2007	629.785	130	0.206	2.560
2008	657.899	138	0.210	2.601
1999-2008	5400.531	671	0.124	1.541

Source: CBO

* Numbers are in billions of dollars

Using the federal budget surplus for the private TSP accounts would still leave the budget in balance. Payroll taxes would remain at their current 12.4 percent level. However, a portion equal to the amount of the budget surplus would be diverted into TSP accounts on a *pro rata* basis. The budget would therefore remain in balance since merely the budget surplus would be diverted.

Social Security's Overall Financial Condition Would Improve

Under the scenario described above, the Social Security trust fund would not be reduced from current projection levels — rather it would likely expand beyond currently projected levels because it would include all of the money invested in the TSP accounts, including the higher yields resulting from actual investment. This should diffuse attacks of those wishing to demagogue against private investment of some payroll taxes, and it also has important fiscal implications: The trust fund would no longer be the paper trust fund it is now — a mere bookkeeping device that currently holds no cash or investments but only specially issued government securities.

Under this approach, the TSP portion would contain actual securities and yield an actual return. The actual increase in value in the TSP investments would increase the overall Social Security balance. Another important effect would be that Social Security's unfunded liability (future benefits that are being accrued by current covered workers) *would begin to diminish* in proportion to the amount of payroll tax diverted into TSP. As the years go by, employees would look to the actual investment of their TSP to fund more and more of their retirement needs, and look less to the promise on paper of Social Security's traditional "trust fund."

Only if the status quo is changed — with private investment — can current surpluses be used to diminish future liabilities. But, what happens when the budget surplus disappears? First, the TSP investments will have had the years during the surplus to have increased economic growth and tax revenue. Those favorable factors should at least forestall federal deficits. Second, budget surpluses will end in any case under the current scenario. Without a change in current operations, the surplus money can in no way offset future liabilities.

Again, this surplus will certainly cease shortly under the current scenario in any case. From a budgetary standpoint, the federal government, in order to meet its obligations, will face the prospects of reducing spending, increasing taxes, or borrowing. The proposed diversion of Social Security payroll taxes into TSP accounts *does not change* this dynamic. In fact, it makes those alternatives *more palatable* if they allow the continued use of TSP accounts. And in the worse case scenario and Congress decided to end the TSP program when the actual surplus revenue stream came to an end, covered workers still would be better off for having had funds contributed into their TSP accounts for a decade, accounts containing real money that won't go away but will continue to grow under each taxpayer's name.

"As Good As What Members of Congress Get"

President Clinton in his 1998 State of the Union Address stated: *"What should we do with this projected surplus? I have a simple four-word answer: Save Social Security first. . . . I propose that we reserve 100 percent of the surplus — that's every penny of any surplus — until we have taken all the necessary measures to strengthen the Social Security system for the 21st century."* However, issuing the challenge does not mean meeting the challenge. Simply "saving" the surplus will do nothing for Social Security [see 2/19/98 RPC paper, "What This President Isn't Telling You About Social Security" for an analysis of what simply saving the budget surplus would mean for Social Security]. Real reform is needed.

"You will be guaranteed benefits as good as what members of Congress get." In contrast to liberals' attempts in 1994 to use this rationale for nationalizing health care, the rallying cry is compelling for Social Security:

- Social Security, the nation's retirement system, is unsustainable in its current form.
- It cannot be saved through higher taxes without threatening the economy.
- Its future liabilities have not only been incurred, but are being incurred at an increasingly rapid rate.

In short, the current system must change in order to survive. Its survival depends on reaping higher returns and that means private investment.

Fortunately Congress and the Administration do not have to fly blind. Private investment in an extensive retirement system has already been tried and is working in the federal retirement system. It's known as the TSP:

- The TSP approach combines the strengths and avoids the weaknesses of other private investment options — increasing returns without increasing risk.
- It duplicates the economic strength of private investment: functioning as a virtual tax cut, it would put hundreds of billions into real investment and divert it from government spending.
- It lowers Social Security's future liability, thus reducing future government spending, taxes and debt, while increasing Social Security's strength.
- And, the emerging federal budget surplus offers a golden opportunity to try this approach on a controlled scale.

The TSP approach for Social Security may not just be *"as good as what members of Congress get,"* but simply as good as it gets for Social Security reform. Senator Judd Gregg, chairman of the Senate Budget Committee Task Force on Social Security and the National Commission on Retirement Policy, listed the TSP approach as a possibility for administering personal accounts. It is certainly an option Congress and the Administration should seriously examine.

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